The relevance of firm size when reforming the business environment

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Abstract

Evidence suggests that smaller firms face a more difficult business environment (BE) than large firms. It is debateable, however, as to whether BE reform should therefore specifically account for small firms or whether reforms should seek to create a level playing field for all enterprises. This paper addresses this issue by asking: *is firm size relevant for the reform of the business environment?* As a background paper, the aim is to provide a balanced assessment of the various arguments without providing a definitive answer or giving preference to one point of view.

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Executive summary

- The paper joins two important issues for the donor community:
    - reform of the business environment (BE) as a means to promote enterprise development;
    - whether private sector development efforts should focus on smaller enterprises (SMEs) or enterprises of all sizes.

  Thus, the paper asks whether or not BE reform should focus on smaller firms. The paper is intended as background for a debate and therefore seeks not to provide an answer to the question but provide arguments and evidence to provoke thought and discussion.

- One way to address the question is to ask whether SMEs make a substantial contribution to key development goals, such as economic growth, poverty reduction and employment creation. SMEs, including those in the informal economy, certainly do contribute substantially to GDP and employment. As well, a large portion of the poor operate or work for micro and small enterprises. However, a recent cross-country study suggests that the size of the SME sector may not have a causal impact on economic growth. (The variable investigated is, more specifically, the SME proportion of total employment in formal manufacturing.)

- Policies and regulations are sometimes based on a *size exemption* (or *size-based compliance threshold*). Such exemptions can lead to:
    - *size traps* in that they inhibit firms from growing beyond the threshold;
    - unfair competition with firms that must comply; and,
    - negative externalities (e.g. environment) or social consequences (e.g. labour legislation).

  These factors must be weighed against the benefits to enterprises (time, cost) of not being required to comply.

- The business environment may be biased against smaller firms due to *created disadvantages* (by policymakers, business lobby groups) or to *natural disadvantages* (lack of capacity and skilled personnel to deal with complex regulations, etc.)

- Exemptions from labour legislation are often made on the basis that smaller firms have less capacity to deal with the requirements. However, exemptions may results in size traps and reduce the protection accorded to workers.

- Small firms are sometimes taxed at lower rates than large firms. A study of 29 OECD countries found that 14 countries offered lower corporate rates, while 15 did not. Other taxation measures have been put in place to support SMEs, including exemptions from VAT. The OECD study did not conclude whether exemptions were justified or not.

- Costly and time-consuming business registration and licensing regulations are a drain on all businesses but may be particularly difficult for small firms. Progressive fee schedules might be used.

- There is interesting new evidence that weak legal and financial systems affect the growth of small firms more than large firms. The general development of financial and legal systems is likely to help small firms (but not necessarily large firms) to grow. Other measures might include the creation of asset registries and credit bureaux.

- In some cases, governments may wish to help large firms in specific sectors to achieve minimum efficient scale (MES). This allows such firms to compete in export markets such as automobiles, steelmaking and shipbuilding. In other sectors, governments may wish to support the development of enterprise clusters that are made up predominantly of small firms.

- Corruption is known to affect economic growth negatively. Recent evidence suggests that small firms may be more affected than large firms.

- It is important for public welfare that large companies do not dominate markets and create unfair competition. In some cases, a collusive group of small enterprises may also corner a market.

- The informal economy is an important BE area that relates almost exclusively to micro and small firms.

1. Introduction: the context and importance

The development of a vibrant private sector is considered to be a key component of the broader effort to support economic growth, employment and poverty reduction in developing and transitional economies. While private sector development, or PSD, as a development approach has been around for several decades, there continues to be considerable debate and constructive disagreement about how best to promote the private sector and how best to target different elements of the private sector.

The current debate is evolving in two ways. Firstly, there is increasing agreement that support for reform of the business environment is a critical element of PSD because it can significantly affect a maximum number of enterprises. The BE is a broad concept that includes those factors that affect business performance and are external to the enterprise. Fundamental to the BE are the 'rules of the game' as determined by the policies, the laws and regulations governing enterprises and markets and the social and cultural context.[1] Secondly, a debate has emerged about whether donors and governments should pay particular attention to small firms or, instead, should seek the development of firms of all sizes. The former view is based on the fact that many (most) poor people work for smaller firms and that these firms face particular constraints on their performance and growth. The latter view holds that enterprises of all sizes can and do contribute to development goals.

These two fundamental issues are joined together in this paper, which asks: *is firm size important for the reform of the business environment?* For clarity, the paper uses the term *size-neutral* to depict arguments, evidence and viewpoints that support a 'no' response to the questions, and *size-specific* for the 'yes' response. As a background paper, the purpose here is not to argue for one particular point of view but, instead to provide a balanced assessment of both sides of the argument. This includes the presentation of contrasting viewpoints and research that might shed light on the issue. In short, the paper is meant to stimulate thinking and encourage readers to formulate their own views.

2. Contested issues: level playing field, inherent disadvantages, impact

There is good recent evidence that SMEs face a more difficult BE that large enterprises (Schiffer & Weder 2001; Beck *et al.* 2005b). This evidence, reviewed below, is based on a survey of over 4,000 firms in 54 countries and suggests that reform of the BE would significantly benefit SMEs, but not LEs which are less constrained by that environment. Thus what is not debated here is whether SMEs face a more difficult BE. Instead, the emphasis is on whether that difference, where it exists, should affect the approach to reform. In short, should donors support general size-neutral reform or more size specific reform?

The question can be approached two ways. One, we can take each area of the BE and consider whether a size-specific or a size-neutral approach should be taken. This is an

[1] For a full discussion of what constitutes the business environment, see White & Chacaltana 2002: 15-17. There is an international aspect to the BE which includes markets and international agreements. Nationally, the BE has macro, mezzo and micro aspects. While the rules governing markets are a key aspect of the BE, markets themselves are also part of the BE.

obvious approach and will structure the analysis throughout most of the paper. A second approach, however, asks first whether SMEs, in fact, do make a contribution to the larger development goals of donors, such as economic growth, poverty reduction and employment creation. If we find that they do not, then the case for size-specific reforms becomes less convincing. Yes, SMEs may face a more difficult BE than large enterprises and size-specific reforms may assist them, but so what? Do doors want to dedicate time and money to undertaking sizes-specific forms when they may not contribute to larger development goals? This second line of argument is not treated in depth in this paper but is discussed in Section 2.2 below.

2.1 Level field, inherent disadvantages and thresholds/progressivity

The existence of size-specific disadvantages may arise from two sources:

- *Created disadvantage*: Reforms are needed to create a level playing field that is currently biased in favour of large enterprises. The bias, in this regard, has not arisen naturally but has been created through the intended or unintended actions of policymakers, lawmakers, lobby groups, etc.
- *Natural disadvantage*: SME face a natural disadvantage due to their size and thus size-specific reforms are needed to ensure that the BE (laws, regulations, culture) do not impose a disproportionate burden on them.

Regarding the first approach, reform can involve removing certain advantages that LEs have gained over SMEs. This suggests that for some reason, LEs have been granted advantages that SME are not granted (access to import rights, access to government contracts, a more favourable tax regime, access to a government-owned natural resource). These advantages may often arise from the increased lobbying power or political connections of large firms. Levelling the playing field means ensuring that all firms have the same rights, responsibilities, administrative requirements, etc. In this way, reform is designed to 'undo an LE advantage'.

Regarding the second approach, reform might be needed to overcome some natural constraint based on size. The common notion is that smaller firms have less internal capacity to cope with the legal, administrative and regulatory requirements imposed by governments. They lack the personnel, accounting and legal expertise that large enterprises maintain in-house. They have less time to obtain the required information. Size-specific reforms may be needed to help them handle these requirements.

In discussing size-specific legal and regulatory provisions it is important to keep in mind their pros and cons. Reforms based on a *size exemption* (or *size-based compliance threshold*) can reduce the regulatory requirements of small firms. For example, a firm having less than 10 workers may be exempt, either fully or partially, from regulations pertaining to hiring and firing, occupational health and safety, social security contributions, etc. However, these exemptions can also lead to the creation of *size traps* based, as they are, on *discontinuities* in compliance. A size exemption can have three negative consequences: it can create a disincentive for firms to grow beyond the threshold; it can create unfair competition with firms that must comply; and, it can have negative social impacts or negative public externalities (e.g. exemption from labour legislation, from environmental standards). These possible negative consequences must be weighed against the benefits of the exemption for the performance and growth of the enterprise and for the entrepreneur and workers.

A similar approach to size-specific reform is that based on the principle of progressivity, in which a graduated schedule of payments or regulatory requirements is set out on the basis of size. In short, the payment or regulatory requirement increases progressively with size. This approach avoids the larger discontinuities created from the imposition of a single threshold; i.e. the marginal increase in compliance cost/effort is less likely to be a barrier to growth. Progressivity is often used in setting fees for business registration permits, for example. It is a size-specific measure that can be justified on equity grounds (just as it is in most systems of income tax).[2]

2.2 Evidence on the connection between SMEs, growth and poverty reduction

Fundamental to the size question is the issue of whether the development of small enterprises has a positive impact on the key aspects of development – poverty reduction, employment creation and economic growth. Small enterprises may face a more difficult environment than large enterprises but if large enterprises contribute more to development then it can be argued that the BE should be biased in their favour. The converse is, of course, also true: if SMEs contribute more, then the bias might be in their favour.

But how do we know what types of enterprises contribute most to the development process? This is an empirical question. We know that SMEs constitute the overwhelming majority of all business entities in both developed and developing countries (commonly over 95%). As well, formal SMEs and informal enterprises[3] account for 62-69% of GDP across low, middle and high income countries and for 69-72% of employment in middle and high income countries. The employment share in low-income countries is 47%.[4] Furthermore, small firms are most often locally owned and thus support the development of a strong domestic private sector. A certain share of the large companies in any economy is foreign-owned and this share is significant in some developing countries. In some sectors, small firms can sometimes be an important source of product and service innovation.

Given the above figures, one could argue that creating a supportive general business environment *means* creating an environment suited to SMEs. Donors have tended to see a strong link, at least conceptually, between SME development and poverty reduction, in part because so many of the poor operate or work in micro and small enterprises (Vandenberg, 2005). As work by the Donor Committee suggests, 'there are clear links between reduction and PSD [and] SME development becomes relevant as a tool for private sector development and poverty reduction because it broadens participation in the private sector and, because it involves many people who live in

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[2] One could argue that all citizens should pay the same lump sum amount of income tax because they all receive the same access to roads or courts or protection from foreign invasion.
[3] These categories do not include small farms. The figures in this paragraph on employment and income are from Ayyagari *et al*. (2003).
[4] The figure is lower for low-income countries because they have a higher percentage of the workforce engaged in farming.

poverty, provides a mechanism for their empowerment" (White and Chacaltana, 2002: 24).

Related to these measures are questions of whether SMEs create more jobs than large firms, whether they are more innovative and whether they provide higher wages and better standards of work. While it is difficult to generalize across time and geography and while a proper discussion is beyond the scope of this paper, many of the commonly espoused benefits of SMEs do not stand up to rigorous empirical scrutiny.[5]

One recent study that does require more detailed discussion here is that by Thorsten Beck and his colleagues (Beck *et al*., 2005). Their study tests for the impact of the size of the SME sector on economic growth, poverty and income inequality. In addition, it includes a variable for the impact of the BE on economic growth. Thus, the results are highly relevant to the issues discussed in this paper.

The results of the study can be summarized as follows:

- the size of the SME sector is positively *correlated* with economic growth;
- however, the size of the SME sector does not appear to exert a *causal* impact on growth.

Furthermore, the indicator for the size of the SME sector is the proportion of SME employment in total manufacturing employment. Thus, the corollary of the above results would include:

- the size of the LE sector is not correlated with economic growth, and,
- the size of the LE sector does not exert a causal impact on economic growth.[6]

In effect, the results tend to suggest that the firm structure of manufacturing production does not matter for economic growth, or to phrase it more positively, economic growth can be achieved through different combinations of SMEs and LEs.

Furthermore, there are three problems with the indicators and the methodology. The main concerns are the following.[7] First, the SME variable is the proportion of SME employment in total employment (in the manufacturing sector). In this context, a larger SME sector means a smaller LE sector. Thus, it is not a question of whether SME sector is expanding but whether its size is growing *relative* to the LE sector. Nonetheless, it is still interesting that a larger SME sector is correlated with economic growth. (We might explain this through better inter-firm relations resulting from reduced transaction costs that make firms more likely to out-source component production or services.) Second, the analysis deals only with firms in the manufacturing sector, where, due to scale economies, smaller firms are naturally

[5] For reviews, see Hallberg (1999) and Vandenberg (2004).
[6] This result is stated here in layman's terms, given the expected broad readership of the paper. An economist/econometrician would write, more precisely that: 'we cannot reject the null hypothesis that the SME-size variable is not significantly associated with the dependent variable (economic growth) once we control for reverse causation or simultaneity bias (i.e. that a third factor is driving both)'.
[7] The authors do, in fact, acknowledge some of these limitations and propose remedies (Beck *et al*., 2005a: 10-11)

disadvantaged. And third, the analysis does not deal with productivity or competitiveness. It is a larger – not a more vibrant – SME sector that is considered.

One final point might also be made about this important study. The paper has gone through considerable redrafting. In the initial drafts – which may be better known in the donor community – the results provided qualified support to the notion that a better BE (for all enterprises) supported economic growth, a more even income distribution and poverty reduction (Beck *et al*. 2004: 24-25). The message that flowed from these results was:: don't focus on SMEs but promote a good BE for all firms and economic growth will result. In turn, growth will, *pace* Dollar and Kraay (2005), lead to poverty reduction.

The final versions do not support this message, however. The BE is not a focus of these versions and the importance of the BE is not discussed. Nonetheless, a BE variable is included in regressions on economic growth (as a control variable) but is found not to be significant.[8] In technical terms, we cannot reject the null hypothesis that a better BE does not have a causal impact on economic growth. In plain terms, the results do not provide support for the idea that a better BE is good for growth. The importance of a good BE for growth is, of course, supported by much of the empirical literature on economic growth.[9] Furthermore, Beck and his colleagues have produced other studies, discussed below, which show that an improved financial and legal environment (which are parts of the BE) allows SMEs to grow larger.

3. Synopsis of the main pro and contra views or arguments

The 'business environment' is a broad concept that, as noted, includes laws, regulations, policies, markets, culture and other elements. Given this diversity, it is useful to break down the BE into it component parts. This issue-by-issue review is provided below.

In working through this review, it is probably healthy that the intended reader, who is working for or with a donor agency, not only considers conceptual and practical issues. S/he might also consider whether size-specific policies or programmes exist in his/her own country. In fact, they do in many cases (credit programmes, tax dedications, simplified administrative procedures, etc.). Donors may in some cases be advocating for one approach to developing countries while another approach is taken in their own countries. There may be reasons for this duality (e.g. different levels of bureaucratic competence) but there also may be good reasons for size-specific actions in developed countries that should also apply to developing countries. The reader may also feel, of course, that SME programmes or policies in his or her own country should be eliminated.

[8] The result may stem, in part, from the fact that BE is not the variable of interest in the regressions and, therefore, the regression sample is based on the availability of data on SME share in manufacturing and not on the BE.

[9] Barro (1991), for example, shows that economic growth and investment are inversely correlated with political instability, price distortions on investment goods and the ratio of government consumption to GDP. Similarly, Mauro (1995) finds that economic growth is inversely correlated with a weak legal system and high levels of bureaucracy.

Advocacy

The playing field may not be level because LEs have successfully lobbied for preferential treatment. Individual LEs certainly do have greater political clout vis-à-vis policymakers and politicians than do SMEs. Indeed, in some countries, notably those in the developing world, we can speak of the 'capture' of governments by big business (Thomas *et al*. 2000: 135-168). This often works through elite linkages in which powerful families hold key posts in both large companies and the government. In addition, large foreign enterprises are often able to negotiate or avail themselves of tax and regulatory incentives including those related to export processing zones and monopoly or oligopoly positions. While the latter has been reduced in recent years, it persists in some countries.

In addition, LEs often control the main enterprise lobby organizations (business associations or federations, national employers' organizations, exporters' associations, etc.). In some countries, LEs make up the majority of the membership in these business groups. In many countries, however, they do not. An ILO survey of national employers' organizations in 71 countries found that on average 86% of members were SMEs (ILO 1999: 26).[10]. Similarly, members surveyed for the International Organisation of Employers' Annual Meeting for European Members in 2004, found that over 80% of the members of these organizations were SMEs (Ramirez, 2004). The membership does affect the policies that are espoused by a business organization but the link between membership numbers and the policies espoused may not be a direct one. The key decision-makers (and board members) may still be drawn from large enterprises.

It is also true that distinct small business organizations can successfully lobby for their members. A prime example is the Canadian Federation of Independent Business, which was born out of an effort to challenge proposed tax changes that would have greatly aided large firms and disadvantaged small ones. The CFIB has successfully challenged or worked with the government on a range of SME issues including taxation, regulation and credit.[11]

Labour legislation

Restrictive labour legislation can make it difficult and expensive for enterprises to hire, maintain or shed workers. In the Indian state of Uttar Pradesh, for example, enterprises must comply with 38 central laws and 10 state laws related to labour. Enterprises face the burdens of maintaining diverse registers, filing returns and addressing inspectors. They are often compelled to engage expensive legal counsel to sort through the requirements and many decide to risk the penalties rather than bear the cost of compliance (Chandra & Parashar 2005: 10). Small enterprises find it particularly difficult to navigate this spaghetti plate of legislation. At the same time, the purpose of labour legislation is to protect workers against such things as occupational hazards, unfair treatment, illness and the loss of employment. It also

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[10] However, in some cases medium enterprises were defined as having up to 1,000 workers.

[11] A brief case study on the CFIB can be found in 'Reaching out to SMEs: An electronic toolkit for employers' organizations', CD-ROM (Geneva: ILO, 2005). See also, www.cfib.ca.

	Issue	Enterprise size is not relevant	Enterprise size is relevant
1	Advocacy	SMEs have their own representative organizations that can influence government policy (CFIB in Canada); SME can support or free-ride on advocacy efforts of business organizations dominated by large firms	Large enterprises are better able to advocate for supportive policies for themselves given both direct access to politicians and government officials and their control of representative organizations (employers' organizations, business associations)
2	Labour law	All workers should be protected by labour law and labour policies regardless of enterprise size; exemptions can lead to size traps, i.e. enterprises stay small to avoid regulation.	Small enterprises are less able to support costs and administration of labour laws (OSH, sick leave, benefits, social security contributions) and simplified systems of compliance are needed
3	Financial sector policies	General reform and development of the financial sector will relieve the financing constraints of SMEs and help them to grow (Beck *et al*. 2005b).	Collateral requirements are difficult for small enterprises; higher per unit administration cost for banks reduces lending to small enterprises; evidence suggests small firms more constrained by financial underdevelopment (Schiffer & Weder 2001; Beck *et al.* 2005a)
4	Poverty reduction	A recent study by Beck *et al*. (2005b) suggests that the size of the SME manufacturing sector has no causal impact on economic growth or poverty reduction	The use of indicators in Beck *et al.* (2005b) is weak, i.e. focus on manufacturing, on size of SME sector, on formal firms, etc.
5a	Taxation – level/rate	Flat tax (i.e. without progressivity) provides fair treatment to all firms or owners/shareholders	Progressive tax schedule allows small firms to reinvest and owners to retain more of their wealth (raising household income, allowing re-investment)
5b	Taxation – administration	Firms of all sizes find it costly to comply and to employ staff to collect and remit indirect taxes	Need for simplified procedures for SMEs because few or no administrative/accounting staff that makes it costly to understand and comply with tax regulation
6	Corruption	All firms affected by general government corruption (waste of resources) and by demands for bribery payments; large firms pay higher bribes	Small firms face more problems with bribery and other corrupt practise because they are less able to defend themselves or seek recourse to politicians; for whatever reason, Schiffer & Weder (2001) find that SMEs more bothered by corruption
7	Registration, licensing	When fees are set as a rate of some measure of size, i.e. output, investment or employment, small firms are not disadvantaged (Nairobi)	When fees are set at fixed amounts, they are proportionately more costly for small firms

8	Minimum efficient scale (MES) vs. collective efficiency (clusters)	Large and small firms combine to generate efficiencies through subcontracting, networking, clustering, i.e. third Italy, Taiwan, Sailkot (Pakistan)	Large size is necessary to achieve MES to compete internationally, i.e. Korean cars, steel
9	Competition policy (anti-monopoly) and government procurement	Enforcing competition policy *means* creating a level playing field for enterprises of all sizes.	Large firms can control the market through monopolistic or oligopolistic pricing practises, high advertising expenditures, control of primary and secondary supply sources, bundling (Microsoft)
10	Entrepreneurship culture and women's entrepreneurship	Promotion of such a culture should target all elements of society. Gender bias should be removed in all policies and apply to firms of all sizes.	Culture promotion efforts are aimed at the creation of SMEs. Many small firms are headed by women who face discrimination, in terms of legal rights to property, access to credit, credibility with suppliers; requires affirmative action for these enterprises
11	Skills and training	A literate, numerate, skilled and educated workforce benefits all firms	Small firms are less able to provide in-house training or to allow employees to be away for external training
12	Physical infrastructure	Good physical infrastructure makes markets work for all firms	Small firms tend to be located in areas that are under-serviced by transport, communications, water, electricity, sewage, etc.
13	Legal system	All firms have access to the same legal system	Large firms better able to finance access to legal system; costs of legal counsel and court fees proportionately higher for small firms

protects their right to associate and bargain collectively with employers.[12] An appropriate labour regime for any type of enterprise would balance workers' welfare with the need for enterprises to adjust to changes in internal work organization and market demand.

In some countries, micro and small firms are fully exempted from labour legislation. However, these cases are relatively rare – a recent review of 178 countries found that only 10 per cent of those countries provide such an exception (Daza 2005: 23-24). At the same time, there are few countries in which micro and small firms are required to comply fully with labour legislation. The latter is likely due to an effort to create a lighter regulatory burden for smaller firms and the recognition that it is not possible, administratively, for the government to ensure full compliance (Fenwick 2005: 36). Somewhat more than 10 per cent of countries provide an exemption from occupational health and safety legislation, while less than 10 per cent provide

[12] Labour legislation can include: minimum wage, overtime and working time limits, paid time off, unemployment insurance, workers' compensation, collective bargaining and freedom of association, anti-discrimination and equal opportunity, forced or child labour, unjust dismissal, health and safety, advance notice and consultation for large scale layoffs, parental or family leave, employee consultation and the right to transfer entitlements (Fenwick 2005: 20).

exemption from the full scope of social security laws (Daza 2005). Many of the exemptions from labour legislation are found in former British colonies where legislation was modelled on the (British) Factory Act.[13]

Thus, on the one hand, it can be argued that all enterprises should comply with labour legislation to protect workers and avoid size traps. On the other hand, small enterprises can find it particularly difficult to handle the administrative and regulatory burden of full compliance with labour legislation. They commonly lack the legal and administrative personnel necessary to sort through and comply with complicated legislation.

Financial sector policies

The difficulties that small firms face in accessing finance are well recognized. Recent work by Beck *et al*. (2005b) has sought to quantify the differences between large and small firms in this regard. A perception survey administered to about 4,000 enterprises in 54 countries revealed that the growth of small firms was more affected by financing obstacles than was the growth of large firms. On a range of financial issues, the growth of LEs was affected only by high interest rates. By contrast, the growth of small and medium-sized firms was affected by:

- collateral requirements
- high level of bank paperwork and procedures
- need for special connections with banks
- banks' lack of money to lend
- access to equipment leasing finance
- high interest rates.

The growth of small firms (but not medium-sized ones) was also hampered by the difficulty of gaining access to export financing (*ibid*.: 161). The study concludes that the results 'provide evidence that financial obstacles have a much greater impact on the operation and growth of small firms than that of large firms' (*ibid*.). The researchers also found that development of the financial system will loosen the financing constraint and improve access for smaller enterprises.

The conclusion drawn by the researchers is that it is the overall development of the financial sector that will help SMEs. This prescription can be viewed as either a size-neutral or size-specific approach. It is size neutral because it seeks to develop the overall financial sector. However, because we know that such development will affect the growth of SMEs – and not LEs – then it can be viewed ultimately as a size-specific measure. The financial sector is being reformed because we know that it will help SMEs.

Issues not discussed in the above study include the absence of asset registries and credit bureaux which make it difficult for smaller firms to prove creditworthiness. Entrepreneurs in the informal economy find it particularly difficult to use assets as collateral (de Soto 2000).

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[13] These figures are the percentages of countries not the percentage of the workers from the 178 countries surveyed. One of the former British colonies that still base their legislation on the Factory Act is India, which contains one-sixth of the world's population.

Physical infrastructure and utilities

Firms of all sizes need reliable physical infrastructure and access to utilities. Thus, a size-neutral approach is probably needed for private sector development. It is true that in developing countries, infrastructure and utilities access is often weak and unreliable. Furthermore, coverage tends not to be comprehensive leaving large patches (or whole areas) un- or under-serviced. Government pre-occupation with large enterprises, prompted by LE lobbying, may result in better services for large enterprise areas (industrial estates) and the relative neglect of areas populated by smaller firms (light industrial areas). This can translate into a competitive disadvantage for smaller firms. A level playing field would require equal provision by firms of all sizes but would be undertaken with a view to supporting SMEs.

In some countries and some industries, firms are forced to take it upon themselves to provide (public) services. Roads and bridges built by mining or forestry companies are the prime examples. This may be the cost of doing business for large enterprises, especially multinationals. In other cases, relatively cheap forms of private utility provision may be accessible to all sizes of firms (e.g. backup generators).

Legal system

Evidence from Beck *et al*. (2005b) suggests that the smallest firms are more severely affected by a weak or underdeveloped legal system. The results are based on a perception survey of over 4,000 enterprises in 54 countries. Firms of all sizes feel that a weak legal system is an important constraint on business operations. However, only in the case of small and medium-sized firms were the problems found to have a significantly negative impact on enterprise growth (based on sales). Tests on a number of the specific aspects of the legal system showed significant differences between large and smaller firms regarding the impact on business growth. However, these factors were not, for the most part, significant in affecting enterprise growth in each firm-size sub-sample.

The impact of a poor legal system on small firm growth was worse that on larger firms and this difference was statistically significant on the following issues:

- availability of information on laws and regulations;
- overall quality and efficiency of the courts; whether the courts are perceived of as fair and impartial;
- the quickness of the courts in dealing with cases;
- whether court judgements are consistent; confidence in the legal system to enforce contracts and property rights; and
- confidence in the legal system to uphold property rights three years ago and currently.

Efforts that would improve legal efficiency generally are shown to improve the performance of small and medium-sized firms but appear to have no impact on large ones. Related research on property rights and financing (Beck *et al.* 2004b) suggests that that stronger property rights tends to generate a more significant effect for smaller than larger firms on promoting access to external financing. The effect works bank and equity financing.

There is little reported evidence of the impact of more decidedly size-specific approaches such as the development of small claims courts to handle the disputes of smaller firms.[14] Such courts would allow a complainant to present her case without the use of legal counsel. Small firms tend to find it costly to address legal issues because of the need to secure outside legal expertise. LEs tend to have legal personnel on staff, although they are nonetheless costly to retain.

Business registration and licensing

The time and expense needed to start a business is often a telling sign of whether a country's regulatory environment is friendly or onerous. Indeed, it often appears rather bewildering, given the importance of enterprise activity to an economy, why someone in one country can register a business in a few days with minimal capital while in another country it takes 198 days (as in Laos) and in another requires $61,000 in starting capital (Syria).

The cost and time needed for start-up is an important factor in the creation of new businesses, which are predominantly SMEs. When business registration and other license fees are set at fixed amounts, they are proportionately more costly for smaller firms and thus can inhibit start-up. This might suggest a size-specific approach in which fees are set at rates of some reassure of size (i.e. initial investment, initial employment, average per capital income, etc).[15] In addition, it might be argued that applications from larger firms should be scrutinized more intensely given their large future impact on competition, employment, the environment, etc.

Conversely, low fees and short waits are beneficial to firms starting at all sizes. This suggests a size-neutral approach to the issue might be taken.

Taxation

A recent review of corporate tax rates in OECD countries revealed an almost even split on whether lower rates were provided for SMEs (Chen *et al*. 2002). Fourteen of the 29 countries had lower rates for SMEs, while the other 15 members made no distinction. The U.S. had one of the largest differences with a basic rate of 35% compared with an SME rate of 15%. The basic rate in the U.K. was 30%, falling to 10-20% for SMEs (*ibid.,* 13).

In addition, countries have other corporate tax provisions to assist SMEs. In 1999-2003, South Korea granted SMEs a 50% reduction in income and property taxes for up to five years and exemption from registration and transaction taxes for two years. Several countries have special tax provisions for investments in high-tech industries and/or for R&D. Italy and the UK have special R&D tax credits for SMEs that are among the most generous. Other provisions include credits for investments in the

[14] Or more correctly, the smaller amounts of the disputes brought by small enterprises.
[15] The annual *Doing Business* report of the World Bank (2005) records the absolute number of days and the cost as a percentage of a country's average per capita income. The implication is that the time and fees should be kept to a minimum and relate to an average person's income level.

equity of SMEs and capital gains exemptions. SMEs are exempt from VAT in most OECD countries and there are reduced rates for SMEs in those countries that do not provide full exemption. Earnings from self-employment (non incorporated businesses) are taxed under general provisions of the tax code for employed persons. A number of countries have lower tax rates, simplified procedures or require lower social security contributions for the self-employed compared to wage earners. All these provisions are part of a size-specific approach to taxation.

The OECD study notes that that lower taxes are usually motivated by a recognition that incorporated SMEs and the self-employed face a number of constraints or disadvantages, notably the relatively higher cost of compliance with government regulation and the reduced access to financing. SME profits tend to be lower and therefore provisions are also made on equity grounds.

However, the OECD cautions that some of the broader reasons for providing concessions to SMEs may not be well founded. It suggests that ‘a large proportion of established SMEs are not significant creators of new jobs or generators of innovations’ and therefore tax concessions may not be justified on these grounds (*ibid*., p. 19). Concessions can also create size traps as enterprises stay small to avoid higher taxation. These various arguments support a size-neutral approach to taxation and are likely to be part of the rationale invoked by the many countries that do not provide lower corporate rates for SMEs.

Skills training

Large enterprises are more likely to provide for or support the skills upgrading of their workers. There are probably four main reasons why this is the case. First, LEs have a lower cost of capital for investments in training. Second, the per-worker cost of training is lower in LEs because of scale economies in training provision. Third, LEs have a wider range of job positions for skilled workers and therefore the workers they train are less likely to move to other enterprises. And fourth, for management training, there are greater opportunities for career advance within the company. At the same time, smaller firms are often less aware of the benefits of training for enterprises performance (Hughes 1997: 13-14).

The natural disadvantages experienced by SMEs in offering training therefore might call for special training credits (i.e. tax deductions) to such firms. If workers do not stay with the firm, there is less loss of the enterprise’s investment (because it is part funded through a tax credit). In addition, government-supported enterprise-based training SMEs generates positive externalities that is captured by the enterprise, large or small, to which a trained workers moves. Generally in the developing world, training institutions are overly centralised and not demand-oriented. Small firms, which rely more on pre-employment and non enterprise-based training are more likely to benefit from skills training policies that make training systems more relevant to the needs of the private sector.

The size-neutral argument would be that training credits should be available to enterprises of all sizes. Training, like education, can be seen as a public good and, furthermore, small firms gain a positive externality when hiring a worker trained by a large firm.

Competition policy and government procurement

Competition can be inhibited by the concentration of market power in one or several very large enterprises. Thus enterprise size is important in ensuring fair competition. Large firms can control primary or secondary supply sources and/or dominate consumer markets. Standard microeconomic theory has long demonstrated that such monopoly or oligopoly situations will generate negative welfare effects. Thus, most developed countries have in place competition policies (also known as anti-monopoly, anti-trust or restraint of trade policies). The European Union has developed a regional policy that is actively applied. Such policies are a direct recognition that large firms with substantial market power can and do behave in a manner contrary to the public interest. Inherently, then, such policies are a size-specific measure to ensure fair competition: they seek to provide a level playing field by limiting the power of large enterprises.

At the same time, governments often restrict competition through their own procurement policies. The quantities demanded in a government contract can be so large that only large companies can provide them. Some donors have worked with governments to ensure better access of small enterprises to contracts for supplies, road and building construction and municipal services. This may mean, in part, breaking down large orders into smaller ones or decentralising purchasing (see examples, ILO 2004: 17, 31, 43, 47).

Corruption

Researchers have long suspected the negative impact of corruption on economic growth. Mauro (1995) was the first to confirm that link in cross-country growth regressions. Recent research suggests that smaller firms may face more corruption and that it has a more material affect on performance compared to large firms (Beck *et al*., 2005b). The evidence is based on data for around 4,000 firms in 54 countries. In a perception response survey, small enterprises expressed significantly higher concerns (frustration) with corruption compared to large firms. Furthermore, these perceptions were justified as the negative impact of corruption on enterprise growth is shown to be highly significant for small firms. It was significant but less so (5% level) for medium-sized firms but was not significant for large firms.

Furthermore, the proportion of a firm's revenues paid in bribes lowers significantly the growth of small and medium firms. By contrast, it does not lower the growth of large firms. The corruption of bank officials also affected growth significantly for small firms but had no similar impact on medium or large firms. In short, large firms do perceive of corruption as an obstacle but it does not affect their growth performance (*ibid*., p. 162). Not surprisingly, the study also found that if a country were able to reduce corruption it would have a significant beneficial affect on small firms.

The results suggest that it is corruption related to small firms that needs to be reduced. This supports a size-specific approach which reforms those institutions (and indeed personnel) that are most in contact with small firms.

Informal economy

An important issue for business environment reform is the informal economy. Many entrepreneurs choose the informal route because the regulatory environment is too burdensome. In other sections, we have discussed the regulatory areas that might inhibit formalisation (business registration and licensing, labour legislation, taxation). In most countries, the informal economy is almost exclusively comprised of micro and small enterprises. The effort to encourage formalisation (by demonstrating the benefits, adjusting the requirements) is not directly a size-specific issue (i.e. the effort is to formalise all informal firms). It does require, however, understanding and sensitivity to the issues faced by small enterprises.

Industrial agglomeration (minimum efficient scale vs. collective efficiency)

In some industries, competitiveness requires the achievement of a minimum efficient scale (MES) of operation and that can mean a BE that supports investments by large enterprises. MES ensures that the large investment made in plant and machinery is recouped through a high throughput, thus ensuring a low per-unit output cost. Low unit costs are required, in turn, to compete globally against other large producers. Mass-market automobiles, chemicals and shipbuilding are three examples in which scale is important. Governments can take an active role in helping large firms to achieve MES through an industrial policy that includes trade, investment and credit aspects.

The successful East Asian industrializing countries used such policies, backed as they were by competent bureaucracies and some level of domestic competition for government support (Wade 1990). The Japanese government rationalised the steel industry – by creating several large from many smaller enterprises – so as to achieve international competitiveness. The South Korean government used industrial policy to protect and support its infant industries and help them to achieve scale and international competitiveness. These successes must be measured against efforts in other countries that only led to the creation of industrial white elephants that were neither efficient nor internationally competition.

Conversely, competitiveness can be achieved in many sectors through the agglomeration of micro, small and medium firms that are organized as *clusters* (Schmitz 1999). These clusters require a BE that supports frequent transacting and collective action (on skills training, marketing, quality standards, etc.).[16] Several large firms will usually be involved in the cluster and undertake final assembly, buying and order organisation and/or marketing. In these cases, reform of the business environment must not consider the several large producers but also the multitude of smaller ones that are an essential part of the cluster. Through government policies or the collective action of sectoral associations, the many firms in a cluster can work toward quality, design, delivery and skills upgrading. Clusters occur in many countries and many industries. Some are the basis for a country's overall industrial development and global competitiveness such the SME-based microelectronics cluster (industry) in Taiwan.

[16] On the skills training aspects of clusters, see Marchese and Sakamoto (2005).

Entrepreneurial culture, including women's entrepreneurship

The development of a vibrant entrepreneurial culture can be important to stimulate business start-ups. This is particularly warranted in countries making a transition from central state planning. In addition, it is relevant for those countries where employment aspirations focus on secure positions in the civil service. Government programs that encourage entrepreneurship, notably through the media or through credit or tax incentives, are generally aimed at younger people. The target also tends to be those who are likely to start a relatively small business. This gives such programs a size-specific focus but, at the same time, the message is aimed at all segments of society.

Programs that focus on encouraging women's entrepreneurship would likely also have as their intent relatively small businesses, at least to begin. The same arguments for encouraging a general entrepreneurship culture, thus, probably also apply for women focused efforts. There is, however, an added equity element that might be an additional society goal for these programs. (Other means of encouraging entrepreneurship include setting friendly tax and regulatory environments for start-ups. These issues have been addressed in other sections.)

4. Implications for the four themes of the conference

This paper is intended to provide a balanced discussion of whether size is relevant in reforming the business environment. As such, the implications fall into two groups, those that support a size-specific approach and those that support a size-neutral approach. Many of these implications have been discussed already in the general discussion in Section 2 and the element-by-element breakdown in Section 3. What is provided here are a few general points are relate to the conference's main themes.

Relevance of size for assessing the business environment

The detailed econometric analysis, discussed earlier in the paper, suggests that size is highly relevant for assessing the BE. That analysis showed that on legal, financial and corruption issues there were significant differences in the perception of BE obstacles between SMEs and LEs. Even more importantly, there were (statistically) significant differences in the likely impact on enterprise growth that would result if some of those constraints were removed. SMEs would grow as a result, but LEs would not.

Assessments of the BE that do not differentiate between large and small firms may mute or obscure the often heavier impact that a constraining environment has on small firms. Statistically, the differences between small and large firms are likely to be averaged out. Thus, in statistical work but also in interview-based studies or other efforts to capture the impact of the business environment, it can be important to account for the perceptions and realities of small firms.

Relevance for designing donor-supported reform programmes

The paper provided little empirical evidence that supported the need for reform aimed at all enterprises. This is despite the fact that the paper was obliged to discuss that point of view. The studies by Beck and his colleagues did not support the need for general reform. Most significantly, the BE variable was not significantly correlated with economic growth, which the authors saw as an important path to poverty reduction. The evidence does suggest, however, that an improved BE for SMEs would have a causal impact on their growth. Whether this would have an impact on economic growth and poverty reduction was not tested.

Relevance for undertaking reforms

A big question, for which the evidence was lacking, was what kind of reform was needed for SMEs. There is little rigorous research that compares more general BE reform efforts with more targeted efforts. This is a highly relevant issue for the donor community given the recent move away from general BDS to sectoral, value chain and cluster approaches as a way of 'making markets works for the poor'. The emerging approach is more holistic, more rooted in economic processes and more open to combining BDS with BE reform (Miehlbradt & McVay, 2005). Should the donor community focus on general BE reforms for all enterprises or on selected combined BE reforms with BDS support for selected sectors, sub-sectors and value chains? This is a key question that requires discussion at the conference and is not answered in this paper.

Relevance for measuring the outcomes and impact of donor-supported reform

As noted in the first part of this section, rigorous research does suggest the need to differentiate between the impacts of the business environment on SMEs and on LEs. There appear to be significant differences in the obstacles facing, and the impact of reform on, these two groups of enterprises. Drawing on those results, it is thus valuable to chart the differential impacts of any donor-supported BE reforms. It is also valuable to compare the results of size-neutral reforms with those of size-specific reforms.

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